Supreme Court, U.S.
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No. 91-1127

In the Supreme Court of the United States

OCTOBER TERM, 1991

ANTHONY J. ACCARDO AND
CLARICE J. ACCARDO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether legal fees incurred in successfully defending criminal anti-racketeering charges are deductible under Section 212(2) of the Internal Revenue Code as expenses incurred "for the management, conservation, or maintenance of property held for the production of income" (26 U.S.C. 212(2)).

2. Whether additions to tax under Sections 6653(a) and 6661 of the Internal Revenue Code, 26 U.S.C. 6653(a), 6661, were properly asserted in this case.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-17) is reported at 942 F.2d 444. The opinion of the Tax Court (Pet. App. 20-27) is reported at 94 T.C. 96.

JURISDICTION

The judgment of the court of appeals (Pet. App. 18) was entered on August 21, 1991. A petition for rehearing was denied on October 9, 1991 (Pet. App. 19). The petition for a writ of certiorari was filed on January 7, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On June 3, 1981, petitioner Anthony J. Accardo, along with 15 other defendants, was indicted by a federal grand jury in Florida and charged with conspiracy to engage in racketeering activity in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. 1961 *et seq.*[1] In addition to criminal penalties, the indictment sought forfeiture to the United States (under 18 U.S.C. 1963) of more than $2 million. Petitioner and the other defendants were alleged to be jointly and severally liable for the forfeiture. Following a jury trial, petitioner was acquitted of the charges against him.[2] Pet. App. 1-2, 21-23.

On their income tax returns for 1981 and 1982, petitioners claimed deductions of $17,500 and $207,000, respectively, for the legal fees incurred in defending these criminal charges. Petitioners claimed that the fees were incurred for the "conservation of property held for [the] production of income" (Pet. App. 23, 27). The Commissioner disallowed the claimed deductions and determined deficiencies in petitioners' income taxes for 1981 and 1982. The Commissioner also determined that petitioners' underpayments of tax for both years were attributable to negligence or intentional disregard of rules and regulations and were, therefore, subject to additions to tax under Section 6653(a) of the Internal Revenue Code. The Commissioner further determined that an addition to tax for substantial understatement

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[1] Petitioner Clarice J. Accardo is a party only because she filed joint income tax returns with her husband (Pet. App. 2 n.2). References to "petitioner" in the singular will be to Anthony J. Accardo.

[2] Eight of petitioner's co-defendants, however, were convicted. See *United States* v. *Caporale*, 806 F. 2d 1487, 1497 (11th Cir. 1986), cert. denied, 482 U.S. 917 (1987).

of liability was applicable to petitioners' 1982 return under Section 6661 of the Code. Pet. App. 2-3, 20.

2. Petitioners contested the Commissioner's determinations in the Tax Court. Petitioners contended that, since the forfeiture claim in the criminal action could have resulted in a money judgment that would have been satisfied out of their income-producing assets, the legal fees paid for the defense of that case were deductible as expenses incurred "for the management, conservation, or maintenance of property held for the production of income" under Section 212(2) of the Code. Petitioners further claimed that the additions to tax for negligence and substantial understatement should not be upheld because they had reasonably relied on the advice of their tax return preparer and their attorney. Pet. App. 24, 26.

The Tax Court rejected petitioners' arguments. The court observed that petitioners' position was "no different from that of any defendant in a criminal or civil trial who faces a potential fine or monetary judgment that must be paid out of income-producing assets such as savings accounts, certificates of deposit, or stocks" (Pet. App. 24-25). The court noted that the deductibility of legal fees depends on whether the litigation arose in connection with a profit-seeking activity, not upon whether a judgment might have to be paid from income-producing property if the case were lost (*id.* at 25-26). The court concluded that the legal fees were incurred in connection with allegations of racketeering, rather than in connection with conservation of property, and were not deductible (*id.* at 26). The Tax Court further held that petitioner had not met his burden of proving that the addition to tax for negligence was not applicable and had not shown that any exception to the mechanical penalty for substantial understatement of income tax liability applied in this case (*id.* at 26-27).

3. The court of appeals affirmed (Pet. App. 1-17). It first ruled that the income-producing assets that petitioner allegedly sought to protect (certificates of deposit) were not subject to forfeiture under RICO because, as the Tax Court had found (*id.* at 24), those assets were not obtained with the proceeds of petitioner's alleged racketeering activity. The court therefore concluded that petitioner could not show that he incurred legal fees to conserve or maintain those assets (*id.* at 3-6). The court further noted that, since petitioner had not been shown to be engaged in racketeering either for profit or as a trade or business, the cost of his criminal defense was not deductible as an expense of doing business under either Section 162(a) or Section 212(1) of the Code (Pet. App. 6). Finally, the court of appeals agreed with the Tax Court that the record did not support petitioner's assertion that the Commissioner erred in imposing additions to tax for negligence and substantial understatement (*id.* at 15-17).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1.a. The ordinary and necessary expenses of conducting a trade or business are generally deductible for tax purposes. 26 U.S.C. 162(a). Similarly, the ordinary expenses incurred by an individual taxpayer for the production or collection of income are generally deductible. 26 U.S.C. 212(1). Even expenses incurred in producing illegal income are generally deductible. Since "the federal income tax is a tax on net income, not a sanction against wrongdoing" (*Commissioner* v. *Tellier*, 383 U.S. 687, 691 (1966)), this Court has held that the expenses of conducting an illegal trade or business, including the defense of a criminal prosecution

arising out of the conduct of such a trade or business, are deductible under Section 162(a) of the Code. 383 U.S. at 694-695.

On the other hand, the Internal Revenue Code expressly provides that personal and family expenses are not deductible. 26 U.S.C. 262. When an individual who has been charged with participation in a criminal enterprise successfully defends on the theory that he was *not* a participant in the enterprise, the legal fees he incurs in defending the criminal charges are nondeductible personal expenditures because they are not expenses incurred in carrying on a trade or business or other income-producing activity. See *Glimco* v. *Commissioner*, 397 F. 2d 537, 539-540 (7th Cir.), cert. denied, 393 U.S. 981 (1968).

Petitioner asserts (Pet. 5) that there is an inherent unfairness in permitting his co-defendants who were convicted in the RICO trial to deduct the legal expenses they incurred in their unsuccessful defenses, while petitioner, who was acquitted, is denied a similar deduction. Petitioner appears to suggest (*ibid.*) that denying him a deduction for these expenses effects an improper penalty on the exercise of his constitutional right to contest the criminal charges lodged against him. Petitioner's argument is misconceived.

This Court has long recognized that tax deductions are a matter of legislative grace and that "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934). The convictions of petitioner's co-defendants in the RICO trial established that they were in the racketeering business, thereby entitling them to deduct the legal fees incurred in their defense as business expenses under Section 162 of the Code. See *Commissioner* v. *Tellier*, 383 U.S. at 694. Petitioner, however,

was acquitted of the racketeering charges and has never claimed that he was engaged in the racketeering business. Petitioner's legal fees are therefore not deductible under either Section 162(a) or Section 212(1) of the Code. There is nothing unfair in denying petitioner a business deduction when he has not even claimed, much less shown, himself to be in business.

b. Apparently recognizing that he was not entitled to deduct his legal fees as expenses incurred either in a trade or business (Section 162(a)) or for the production or collection of income (Section 212(1)), petitioner does not claim that his legal fees were deductible as such. Instead, he seeks to deduct those expenses on the theory that they were incurred for the conservation of property held for the production of income under Section 212(2) of the Code. Petitioner claims (Pet. 7-8) that he qualifies for such a deduction because, if he had been convicted of the RICO charges, (i) a substantial *in personam* money judgment could have been entered against him, (ii) he would have had to satisfy that judgment with certificates of deposit that he owned, and (iii) the certificates of deposit were income-producing property.

The court of appeals properly rejected this claim. In *Lykes* v. *United States*, 343 U.S. 118 (1952), this Court held that, under Section 23(a)(2) of the 1939 Code (the predecessor of Section 212(2) of the current Code), a taxpayer was not entitled to deduct legal fees incurred in disputing the amount of his federal gift tax (343 U.S. at 125-126): [3]

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[3] The specific result reached by the Court in *Lykes* has been altered by enactment of Section 212(3) of the Code, which would permit a deduction in the particular circumstances of that case. See 26 U.S.C. 212(3) (expenses incurred in determination of a tax are deductible). Congress has not, however, changed the general rule of *Lykes* in circumstances in which a taxpayer incurs legal ex-

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. Section 23(a)(2) never has been so interpreted by us. * * *
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> * * * * *
>
> * * * It is not a ground for * * * [deduction] that the claim, if justified, will consume income-producing property of the defendant.

Similarly, in *United States* v. *Gilmore*, 372 U.S. 39 (1963), the taxpayer sought to deduct (under Section 23(a)(2) of the 1939 Code (1952)) the portion of the legal fees he incurred in a divorce proceeding that was attributable to his successful opposition of his wife's claims to certain of his income-producing assets. This Court denied the claimed deduction in *Gilmore*, stating (372 U.S. at 48 (footnotes omitted)):

> [T]he characterization, as "business" or "personal," of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result to a

penses to avoid a liability that would be satisfied out of his income-producing property.

> taxpayer's income-producing property from a failure to defeat the claim, for, as *Lykes* teaches, that "would carry us too far" and would not be compatible with the basic lines of expense deductibility drawn by Congress.

Because the taxpayer's legal expenses in *Gilmore* were incurred in connection with the "personal" matter of winding up his marriage, the Court concluded that those expenses were nondeductible personal expenditures. *Id.* at 51-52.

Under this Court's holdings in *Gilmore* and *Lykes*, the court of appeals correctly denied the deductions claimed in this case.[4] The legal fees that petitioner incurred arose in connection with allegations of his involvement in racketeering activities, not in connection with his ownership of certificates of deposit. As this Court stated in *Lykes* v. *United States*, "[i]t is not a ground for * * * [deduction] that the claim, if justified, will consume income-producing property of the defendant." 343 U.S. at 126. See also *United States* v. *Gilmore*, 372 U.S. at 48.

Petitioners err in relying (Pet. 14-15) on *Petschek* v. *United States*, 335 F.2d 734 (2d Cir. 1964), and *Ruoff* v. *Commissioner*, 277 F.2d 222 (3d Cir. 1960). Those cases allowed deductions for legal fees incurred by taxpayers

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[4] Treasury Regulations under Section 212 also expressly provide that the mere fact that a judgment must be satisfied out of income-producing property will not suffice to render the costs of legal defense deductible under Section 212(2). The Regulations state (26 C.F.R. 1.212-1(m)):

> An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

in seeking to recover specific income-producing property. In *Petschek*, the taxpayer sought to deduct legal fees incurred in an attempt to recover the value of income-producing stock in corporations that were nationalized by the governments of Yugoslavia and Rumania. 335 F.2d at 735-736. In *Ruoff*, the taxpayer claimed deductions for legal fees expended in trying to recover property seized by the United States pursuant to the Trading with the Enemy Act of 1917, 50 U.S.C. App. 1 *et seq.* 277 F.2d at 229. Neither of those cases has any bearing on whether the cost of petitioner's defense against criminal charges can be deemed to have been incurred to conserve income-producing property merely because such property might have been applied to satisfy a personal judgment that could have been entered against him.

2.a. The court of appeals also correctly upheld the civil penalties imposed against petitioners (i) under Section 6653 for negligence or the intentional disregard of rules and regulations and (ii) under Section 6661(a) for substantially understating their tax liability (Pet. App. 12-16). Although petitioner claims that he relied on the advice of his tax return preparer and his attorney in claiming deductions for his legal fees, the record does not support his claim. As the court of appeals observed (Pet. App. 14-15), petitioner simply failed to establish that he relied in good faith upon advice from his tax return preparer or his attorney. Petitioner's disagreement with the findings of the Tax Court, which have been affirmed by the court of appeals, does not merit further review. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

b. Section 6661 of the Code formerly imposed a mechanical penalty when an underpayment of tax exceeded the greater of either ten percent of the amount of tax due or $5,000. See 26 U.S.C. 6661 (1988).[5] This penalty could be avoided upon a showing that there was substantial authority for the taxpayer's treatment of the item generating the underpayment or that the relevant facts affecting the item's tax treatment were adequately disclosed in the return or in a statement attached thereto. See 26 U.S.C. 6661(b)(2)(B)(i) and (ii) (1988). The court of appeals correctly determined that petitioner failed to establish that he came within either of these safe harbor provisions (Pet. App. 15-16). This conclusion rests upon findings of fact that are amply supported in the record.[6] Further review of these factual determinations is not warranted. *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. at 317-318 n.5.

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[5] Section 6661 does not apply to returns due after December 31, 1989. See Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721, 103 Stat. 2395. Penalties for substantial understatement of tax for returns filed after that date are now set forth in Section 6662 of the Code. See 26 U.S.C. 6662(d) (Supp. I 1989).

[6] The Commissioner has discretionary authority to waive the penalty under Section 6661 upon a showing by the taxpayer that there was reasonable cause for the understatement and that he acted in good faith. 26 U.S.C. 6661(c). Since, as the court below found (Pet. App. 17), petitioner did not establish the existence of reasonable cause and good faith, the Commissioner committed no abuse of discretion in refusing to waive the penalty.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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